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IN THE

Supreme Court of the United States

OCTOBER TERM, 1941

No. 503

PALM SPRINGS HOLDING CORPORATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

REPLY BRIEF OF PETITIONER

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May It Please the Court:

The undersigned has just been retained to argue this case and files this brief to ask the court to consider the following points.

Importance of the Question at Bar

Perhaps no tax case will come before this court at the present term presenting a more important question than these related cases now at bar.

The basis of corporate property for depreciation, for invested capital and for computing profit on sale for thousands of corporations is here involved and not only that but the related basis of tens of thousands of security holders who exchanged their securities in the thousands of depression reorganizations. (See note on Judicial Notice of Scope and Effect of the Depression, 81 L. ed. 1103.)

Illuminating one important phase of the question to be decided is the circular entitled "Federal Tax Problems of Railroads In Reorganization," dated August 27, 1941, issued by the Association of American Railroads and by the Railroad Security Owners Association. It states 75,000 miles of railroad are now in process of reorganization, including fifteen major carriers. Many of the other large roads have passed through reorganization. It states the Interstate Commerce Commission prescribed regulations in the *Chicago Great Western* case, *Ex Parte* 138, which require reorganized carriers to show on their books the original cost to the old corporation as the "basis of property"; that the Bureau of Internal Revenue is now contending otherwise and that its contention ought to be eliminated by legislation because it defeats the sound purposes of reorganization, jeopardizes the future credit of the railroads upon which depends maintenance of the property in the public welfare and may prevent the consummation of pending reorganization plans because of the reluctance of security holders to accept drastic reductions in their securities.

Thousands of hotels, apartment houses and industrial corporations went through depression reorganizations and all have the same question.

Insurance companies, like other bondholders, are vitally effected and attention is called to the testimony before the Ways & Means Committee on behalf of the Superintendent of Insurance of the State of Ohio. (See House Hearings on Revenue Act of 1941, pages 479 to 486.)

On a question of such great and far-reaching importance it is submitted the uniform administrative practice, undisturbed for over fifteen years and continued, over the protest of taxpayers, with the acquiescence of Congress, the sanction of the Tax Board and the Courts, ought not at this late date be reversed by this court when its reversal will do irremediable harm and if it is to be changed at all the change should be by legislation which makes provision for allowing to bondholders a deduction for the losses they were denied by the treasury ruling.

Some Aspects of a Broad View of the Question

With present tax rates on individual incomes (starting at 51% on the first dollar over $26,000 and gradually increasing) and on corporation incomes (normal tax 24 per cent; surtax 7 per cent; excess profits tax up to 60 per cent and declared value excess profits tax from 6 per cent to 13.2 per cent) as high as they now are (and they are to be further increased this year) all will concede decisions on important tax questions cannot be made with as little consideration as when the rates were nominal because, due to the high rates, they are so vitally interwoven with the national economic life which in its turn goes to the core of the national existence and the efficient prosecution of the war.

No group of men could hear a complicated technical question of broad national effect argued on Monday and always decide wisely on Saturday (with a variety of other matters to be heard and decided in between) unless a view of the effect of the principle laid down from all angles should be lucidly placed before them by counsel and the result of days and weeks of study and exhaustive consideration of the question by an expert administrative tribunal should be thoroughly digested in the meantime.*

With the thousands of tax cases in its files it is easy for the government to select an extreme and factually favorable case to test any question and such is increasingly becoming its practise.

It apparently has selected in the *Southwest Consolidated* case its most favorable case and it stresses on page 13 of its brief therein (No. 286 this term) that the bondholders for an investment of approximately $1,750,000 will have the benefit of a corporate investment of about $9,000,000 if the Court of Appeals is affirmed.

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*The decision of this court in **United States v. Hendler**, 303 U. S. 564, would have virtually erased the reorganization provisions from the books had it not been promptly repealed by legislation. (See "Studies in Federal Taxation, Third Series" Paul p. 39 and pages 134 to 145.)

The Committees of Congress in recommending the repeal of this decision states as follows:

> "The recent Supreme Court case of **United States v. Hendler** (303 U. S. 564 (1938)) has been broadly interpreted to require that, if a taxpayer's liabilities are assumed by another party in what is otherwise a tax-free reorganization, gain is recognized to the extent of the assumption. In typical transactions changing the form or entity of a business, it is not customary to liquidate the liabilities of the business and such liabilities are most invariably assumed by the corporation which continues the business. Your committee therefor believes that such broad interpretation as is indicated above **will largely nullify the provisions of existing law** which postpone the recognition of gain in such cases. To enable bona fide transactions of this type to be carried on without the recognition of gain, the committee has recommended section 213 of the bill."

(For this report see C. B. 1939-2 p. 518.)

Some other decisions reversed by Congress are **United States v. Michel**, 282 U. S. 656 by sec. 3722(2) of the Code and **United States v. Swift & Co.**, 282 U. S. 468 by sec. 3770(3).

Obviously if the government's contention is upheld in this case the result will be that so far as the depression reorganizations are concerned the Statute will be a nullity.

Superficially considered this seems a very potent argument but thorough analysis of it discloses the havoc its necessary ramifications will cause should it be adopted. It will also reveal that injustice will be done and the government will get a bigger tax windfall if it is adopted than taxpayers will get if it is rejected.

In the first place if the government argument is rejected and if taxpayer's argument is adopted, bondholders who went through depression reorganizations unquestionably must pay income taxes at the constantly increasing rates on every cent they receive in excess of what the bonds cost them, and thus obviously do not receive a tax windfall whereas if the government's argument is adopted these bondholders on thousands of cases must pay income tax at extremely high rates on a large part of the money they invested in their bonds and also the base to the corporation on the property bought with the money procured from the bondholders will be less than its cost.

A lucid illustration of the way the rule contended for by the government in these cases will work is contained in the speech in the Congressional Record of August 25th (Vol. 87, p. a4343) which is reprinted in the appendix to this brief at pages a to c. (Why didn't the government bring up a case like that instead of the *Southwest* case?)

At the bottom of page 13 of its brief in the *Southwest* case (No. 286 herein) the government states:

> "In contrast, the government's position reaches a result that is sound and fair. A new cost basis is adopted for the taxpayer measured by what the creditors pay when they became the owners."

If bondholders have paid $15,000,000 for their bonds and the corporate property had shrunk in the great de-

pression to $4,000,000 and they were denied any loss on what was then considered a reorganization, how is it either sound or fair to adopt a base of $4,000,000? If they only get their investment back they will be taxed on a profit of $6,000,000. Is this fair?

This speech is quoted in the appendix that the court may be fully aware of the consequences that will flow from the adoption of the rule for which the government contends. Under the rule for which the government contends, taxpayers investing fifteen million in bonds might be taxed on a profit of six million although they only get back $10,000,000 of their original investment and actually lose $5,000,000. Also if a corporation bought property for $15,000,000 if the bondholders' money and never deducted any loss it must pay income tax on a large part of the cost of this property when it sells it, *i.e.*, all it gets for the property over its depression value.

In other words, those who sustained losses at the time of reorganization, which they could not deduct because of the treasury holding that a reorganization existed, must pay tax at present high rates on such portion of the losses as they may recover.

The important thing ever to be in mind in tax cases and apparently wholly overlooked by the government in the *Kitselman* case, is that a rule does not merely decide the case at hand but cuts both ways and sometimes with a sharp double edge.

In the *Southwest* case the old corporation actually invested about $9,000,000 in the property acquired by the new one and that old corporation has never been allowed any loss on that investment. This investment is earning the income upon which taxes are being paid.

The theory on which our tax law is drafted entirely divorces the stockholder or the security holder and the corporation and prescribes a separate base for each. It will not do to confuse the two. Examples of how the Statute applicable here cuts both ways are the many cases in which stockholders paid for their stock many times what the corporation invested in its property and contended it should have the cost of their investment as its base. Such contention has been uniformly repudiated both by departmental ruling and Judicial decisions. *Union Petroleum Co.* v. *Edwards*, 7 F. (2d) 301, published as T. D. 3699. *Shipowners Tugboat Co.*, 4 B. T. A. 403. *Monarch Electric & Wire Co.* v. *Commissioner*, 38 F. (2d) 417 (C.C.A. 7th). *Cf. LaBelle Iron Works* v. *United States*, 256 U. S. 377.

The fallacy of the argument that the basis of its property to the corporation should not exceed what the stockholders pay for their stock and of the attempt to connect the two is illustrated by the fact that at this writing U. S. Steel is quoted on the stock exchange at $51 per share whereas the basis to the corporation of its property is over $130 per share.

So Far as the Government's Argument Is Pitched on Le Tulle v. Scofield, 308 U. S. 415, It Is Unsound.

The government's argument, pitched on *LeTulle* v. *Scofield*, 308 U. S. 415, has received long and careful consideration and has been rejected by the following:

(1) The expert and able personnel of the United States Board of Tax Appeals. See 42 B.T.A. at p. 483 and its opinions in all the cases at bar. ("An informed and expert tribunal renders its decisions with an eye that looks forward to results rather than backwards to precedent." President Roosevelt's message vetoing Walter-Logan bill.)

(2) Three Circuit Courts of Appeal composed of able and experienced Judges whom everyone will concede to be among the ablest Jurists in this country. See opinion of Judge Learned Hand in *Helvering* v. *New Haven & Shore Line Ry. Co.*, 121 F. (2d) 985 (C.C.A. 2nd); opinion of Judge Orrie L. Phillips in *Commissioner* v. *Cement Investors*, 122 F. (2d) 380 (C.C.A. 9th); opinion of Judge Sibley in *Commissioner* v. *Alabama Asphaltic Co.*, 119 F. (2d) 819 (C.C.A. 5th). Two of these courts had before them the decision in the case at bar and carefully considered and refused to follow it, pointing out wherein it was in error. Prior to the decision in the case at bar the government itself had successfully maintained the position for which we contend in *Commissioner* v. *Kitselman*, 89 F. (2d) 458 (C.C.A. 7th). Note the very able defense of that decision, signed by Justice Reed, quoted at page 15 of taxpayer's brief in *Alabama Asphaltic Company* case, No. 328 herein, which induced this court to deny certiorari in 302 U. S. 709. The sixth Circuit Court of Appeals independently reached the same conclusion in *Commissioner* v. *Newberry Lumber Co.*, 94 F. (2d) 447.

Again that impressive weight of authority the decisions of the learned court below stands alone. Its *ratio decidendi* is analyzed in Appendix B at pages d to e hereof.

(3) Impartial text writers and Law Reviews with unanimity condemn the theory of the court below. No writer can be found who approves it. See Paul, quoted on page 18 of taxpayer's main brief herein. See Note in 55 Harvard Law Review 298, which

considers all the cases at bar and supports the theory for which taxpayer contends. See note on *Le Tulle* case in 49 Yale Law Journal 1079, which calls attention to the single transaction rule (an answer to the government's attempt to isolate the foreclosure sale) and concludes the continuity of interest test is properly applicable only to the consideration received from the transferee at the completion of the transaction "and the nature of the original investment should be irrelevant in determining the character of the transaction which purports to be a reorganization." See also other articles cited on page 18 of our main brief and 51 Yale Law Journal 128.

In an extensive analysis, covering 18 pages, published in Vol. 1, 1940 C.C.H. Tax Service, at page 63, under Illustrative Cases, the editor reviews all the cases at bar and discusses the dissenting opinions of some of the Board members, points out certain provisions of the Statute which they overlook and conclude that there is no ground for saying the *Le Tulle* case overrules the *Kitselman* case.

A decision which reached the same result as that reached by this court in the *Le Tulle* case was *Worcester Salt Co.*, 75 F. (2d) 251, on substantially the same state of facts. The taxpayer's petition for certiorari in the *Kitselman* case alleged conflict with this decision but on page 14 of its brief in opposition the government correctly distinguished the case by saying: "None of these cases present the situation of a corporation so absolutely insolvent that the old stockholders could have no interest in the reorganization."

Summary of Technical Argument

Taxpayer acquired its property in August, 1932. It contends section 113 (a) (7) of the Revenue Act of 1932 (quoted on page 23 hereof) fixes the basis of depreciation. Whether it does is the issue in this case. The government contends it does not because it says the property was not acquired "in connection with a reorganization." Manifestly, the bondholders controlled this property prior to its transfer to taxpayer and instead of reorganizing and transferring it to the taxpayer they could have sold it to a stranger if they had so elected. After its transfer to taxpayer a 50 per cent control in the property remained in them since they owned more than that amount of taxpayer's stock. See 51 Yale Law Journal 128.

The government's argument that the property was not acquired by taxpayer "in connection with a reorganization" is pitched solely on the contention that conceding this case is literally within the statutory definition of a reorganization, contained in Clause (A) quoted on page 13 hereof, there can be no reorganization without a continuance of shareholder interest (a qualification it says has been read into the Statute by the courts). (The courts have used the word "proprietary" interest not "shareholder" interest).

Assuming, but not conceding, that a stockholder interest must continue, it is of no avail here because there was here a continuity of stockholder interest. It was stipulated and found as a fact by the Board of Tax Appeals that for over eleven months prior to the acquisition of the property by petitioner Warren B. Pinney was the sole stockholder of the prior company owning the hotel (R. 24, 25). He received 1000 common shares of petitioner

out of 7500 or about 13 per cent thereof. (Petitioner also had outstanding 1752 preferred shares.)

In *Helvering* v. *Minnesota Tea Co.*, 296 U. S. 378 (see analysis in C.B. 1937-1 p. 246) 7½ per cent of the transferee's stock was held substantial. In *Helvering* v. *Watts*, 296 U. S. 387, less than 10 per cent was held substantial.

In *G. & K. Manufacturing Co.* v. *Helvering*, 296 U. S. 389, the stock received was less than 1½ per cent of the outstanding stock of the transferee. In *Schuh Trading Co.* v. *Commissioner*, 95 F. (2d) 404, 407, it was even less than 7½ per cent. In *Miller* v. *Commissioner*, 84 F. (2d) 415, 417 (C.C.A. 6th), a substantial continuity of interest is defined as something more than nominal. Under the existing reorganization statute a transfer of property to a corporation for the sole consideration of its voting stock is a reorganization regardless of how small a portion of the transferee's stock it is. (See page 22 hereof.)

It is submitted that neither the words of the statute, authority or reason support the suggestion in note 13 on page 23 of the government brief in the *Southwest Consolidated* case that the stockholder of the old corporation must receive his stock in the new one as a stockholder of the old and for his stock in the old. To so hold would be to superimpose a qualification not in the statute upon a second qualification not in it and an absurd one at that. Suppose you own all the stock and bonds of a corporation which becomes insolvent and you reorganize it and take all the stock of the new company for your bonds. Can it be said you do not retain your proprietary interest in its property or that it does not continue merely because you have not received your stock qua stockholder of the

old company? If the test requires a continuance of proprietary interest it is enough if it does continue and is immaterial how it continues. In this example you have always a 100 per cent proprietary interest in the property.

The substantial continuity of stockholder interest distinguishes the case at bar from most of the others and alone warrants the result reached by the Board of Tax Appeals.

Also, every case, except the two decisions of the court below now at bar, denying a reorganization because of lack of continuity of proprietary interest deals with sales to outside interests and not with internal readjustments among security holders where no new parties come in, albeit the Statute, quoted on page 23 hereof, allows a 50 per cent new interest to come in.

Apart from the above this case is also within Sec. 113 (a) (7) because (1) it falls literally within the language of the Statute defining a reorganization, particularly clauses (a) and (e) thereof, and (2) when the old corporation became insolvent its assets became a trust fund for the bondholders and they alone had a 100 per cent interest therein. *Case* v. *Los Angeles Lumber Co.*, 308 U. S. 106. *Consolidated Rock Products Co.* v. *DuBois*, 312 U. S. 510, 529. A beneficiary of a trust fund has an interest in the trust property. *Blair* v. *Commissioner*, 300 U. S. 5, 13. This interest remained in them after the transfer to the new company. (55 Harvard Law Review, 294; 51 Yale Law Journal 137.) Also the bondholders then had a 100 per cent control over the property and the stockholders had no right to speak. This control remained in them after the transfer.

Express statements in reports of Congressional Committees show Congress considered bondholders might sub-

stitute stock for bonds and be unable to deduct a loss because a reorganization would exist. (See report quoted on page 32 of our main brief; also page 36.) Acceptance of the government contention means it was impossible to reorganize under the Revenue Act a corporation made insolvent by the depression.

There Was Unquestionably a Reorganization Here Within the Literal Language of the Statute.

That there was a reorganization here within the terse, plain, blunt language of the statutory definition of reorganization is conceded (page 9 of government brief herein).

As repeated in *Browder* v. *United States*, 312 U. S. 335, 338: "No single argument has more weight" than that a case falls within the plain words of the Statute.

Petitioner acquired its property in 1932 and the definition of reorganization in that act governs. See Statute (Sec. 113 (a) (12) quoted on page 28 of our main brief. See also *Schwitzer & Conrad, Inc.*, 41 B.T.A. 533, 539, 540.

The applicable statutory definition of reorganization is as follows (Sec. 112 (i) (1) quoted on page 30 of our main brief):

> "(1) The term reorganization means * * * (A) a merger or consolidation (including the acquisition by one corporation of * * * substantially all the properties of another corporation)."

The definition also contains clause (B) which is applicable only if the bondholders are considered the same as stockholders. (A point which need not be considered under clause (A) above quoted.) This definition in clause (B) reads: "A transfer by a corporation of all or part of its assets to another corporation if immediately

after the transfer the transferor or its stockholders or both are in contol of the coporation to which the assets are transferred." *Commissioner* v. *Cement Investors*, 122 F. (2d) 380, 384, holds bondlfolders of an insolvent corporation are in the position of stockholders.

The definition also contains the catch-all phrase reading as follows:

> "or (C) a recapitalization or (D) a mere change in identity, form or place of organization, however affected." (Inadvertently omitted on p. 14 of government brief).

For the reasons stated on page 19 hereof, taxpayer submits its case also falls within above quoted clause (D) defining a reorganization as "a mere change in place of organization, however effected."

To fall within any one of the above definitions is enough for "these clauses have separate legislative histories and were intended to be mutually exclusive." *Helvering* v. *Minnesota Tea Co.*, 296 U. S. 378, 384.

While a number of lower court decisions have stated the reorganization provisions confer an exemption from tax this is not so. As the Committees of Congress first reporting the provisions in 1924 stated:

> "The provisions of sec. 203 of the bill that no gain or loss is recognized from certain exchanges do not grant an exemption and are not so intended. * * * In other words the provisions result not in an exemption from tax but in a postponement of tax until the gain is realized by a pure sale or by such an exchange as amounts to a pure sale." (H.R. No. 179, 68 Cong. 1st Sess. p. 19 and Sen. Rep. 398, 68th Cong. 1st Sess. pp. 14, 16, 17.)

Obviously, in an era like the present, in which tax rates are increasing year by year it is to the advantage of the revenue to postpone tax to a year of higher rates. On the contrary the year involved in the *Pinellas Ice Co.* case, 287 U. S. 462 (1926) was an era of treasury surplus and annually decreasing tax rates. In that case $400,000 cash was paid the seller on December 15, 1926 and the balance of $1,000,000 was payable in cash, $500,000 in forty-five days and $250,000 each in sixty and ninety days thereafter. (*Cf.* Sec. 44 of the Code which provides that on a casual sale of personal property where the initial payment does not exceed 30 per cent, the income may be returned when the notes are paid.)

Incidentally, for a taxpayer who in 1940 sold property for $50,000 cash and $750,000 bonds payable in 1943, to be taxed on all the profit in 1940 as the *Le Tulle* case holds, rather than when the bonds are paid would be a great benefit to him, not only because of lower normal tax rates in 1940 but because the capital gains tax, which is limited to 15 per cent of the profit, may be repealed in 1942 and all gains taxed at the ordinary rates.

The regulations under the 1932 Act (Art. 577, Reg. 77) and since 1924 stated the acquisition by one corporation of substantially all the properties of another was a reorganization. As the court points out in 76 F. (2d) 797 at p. 800 these regulations, and decisions there cited construing them, were approved by Congress which many times reenacted this language without change while these regulations were in force. *Cf. Helvering* v. *Winmill*, 305 U. S. 79, 83.

The above quoted words of the 1932 Act were radically changed in the 1934 and subsequent acts which require,

under this section of the definition, the property to be acquired solely in exchange for stock. The Committees of Congress in their reports said this changed the law.

In *Pinellas Ice Co.* v. *Commissioner*, 287 U. S. 462, 470, it was said the above quoted words in parenthesis "expand the meaning of the terms merger or consolidation" but do not embrace a sale for cash.

Inasmuch as taxpayer corporation in the case at bar acquired all the property of the other corporation pursuant to a bona fide plan of reorganization and in what I.T. 2071 correctly called "the most common type of reorganization" this case, which concededly falls literally within the statutory definition in Clause (A) ought not to be taken out of it by judicial construction.

Indeed the government concedes the case falls literally within Clause (A) above quoted for here the transfer was not made by an intervening bondholders' committee and the government correctly states on page 9 of its brief: "The transaction thus fits the literal language of Clause A of the Statutory definition of a reorganization."

In the opinion in *Minnesota Tea Co.* v. *Commissioner*, 76 F. (2d) 797, 799 (which this court affirmed) it is said:

> "The particular language of the section relied upon by petitioner as showing that there was a reorganization by the transaction between it and the Grand Union Company is 'the acquisition by one corporation of * * * substantially all the property of another corporation.' The language is plain and unambiguous. The ascertainment of its meaning is simple.
>
> "In *Adams Express Co.* v. *Kentucky*, 238 U. S. 190, page 199, the Supreme Court said: 'It is elementary that the first resort, with a view to ascertaining the meaning of a statute, is to the language used.

If that is plain there is an end to construction, and the statute is to be taken to mean what it says.'

"Such has been the doctrine announced in many cases: *United States* v. *Shreveport Grain & Elev. Co.*, 287 U. S. 77, 83; *Matson Navigation Co.* v. *United States*, 284 U. S. 352, 356; *Wilbur* v. *United States*, 284 U. S. 231, 237; *Corona Coal Co.* v. *United States*, 263 U. S. 537, 540; *United States* v. *Standard Brewery, Inc.*, 251 U. S. 210, 217; *Pirie* v. *Chicago Title & Trust Co.*, 182 U. S. 428, 451; *Price* v. *Forrest*, 173 U. S. 410, 427; *United States* v. *Goldenberg*, 168 U. S. 95, 102.

"The doctrine applies with especial force to tax statutes.

"In *Crooks* v. *Harrelson*, 282 U. S. 55, page 61, the court said: 'Finally, the fact must not be overlooked that we are here concerned with a taxing act, with regard to which the general rule requiring adherence to the letter applies with peculiar strictness. In *United States* v. *Merriam*, 263 U. S. 179, 187, 188, after saying that 'in statutes levying taxes the literal meaning of the words employed is most important for such statutes are not to be extended by implication beyond the clear import of the language used' we quoted with approval the words of Lord Cairns in *Partington* v. *Attorney-General*, L. R. 4 H.L. 100, 122, that 'if the crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the spirit of the law the case might otherwise appear to be. In other words, if there be admissible in any statute what is called an equitable construction, certainly such a construction is not admissible in a taxing statute, where you can simply adhere to the words of the statute.'

"In *Van Camp & Sons* v. *Am. Can Co.*, 278 U. S. 245, page 253, the court used the following language: 'The words being clear, they are decisive. There is nothing to construe. To search elsewhere for a mean-

ing either beyond or short of that which they disclose is to invite danger, in the one case, of converting what was meant to be open and precise, into a concealed trap for the unsuspecting, or, in the other, of relieving from the grasp of the statute some whom the Legislature definitely meant to include.' "

Congress, at the time it enacted the foregoing definition in 1932, certainly knew that reorganizations such as this one were taking place by thousands and that they fell squarely within the literal words of the law and if it had intended to exclude them from the plain terms of the Statute certainly could and would have done so. On the contrary, the Committee reports, quoted at pages 31 to 36 of our main brief, confirm that it intended to include them. As pointed out in *Crooks* v. *Harrelson*, 282 U. S. at p. 60, while this court has the power it has no constitutional right to exercise legislative power and must restrain itself from so doing.

The Application of Clause (B) of the Definition to the Case at Bar.

Since it is conceded that the situation at bar is literally within clause (A) that should be enough.

However, it should be pointed out *Commissioner* v. *Cement Investors*, 122 F. (2d) 380, 384, also holds clause (B) applicable on the ground that the bondholders were stepped down to the position of stockholders by the insolvency and were in control of the corporation to which the assets were transferred.

What is the meaning of the word "stockholders"? Certainly, one may be a stockholder who only holds non-voting stock entitling him to share only in the assets on dissolution. There is a wide variety of stock, including debenture

stock, and it has been held that a policyholder in a mutual insurance company is a stockholder within the meaning of that word in its charter. (*Huber* v. *Martin*, 105 N. W. 1031, 1038, 127 Wis. 412.) Here the right to say what would be done with the assets passed to the bondholders who could have sold them to strangers or recapitalized the old corporation, substituted stock for their bonds and eliminated its sole remaining stockholder instead of reorganizing and issuing 1000 shares of the new corporation to him.

In its brief in the *Kitselman* case, quoted on page 20 of our main brief herein, the government stated:

> "Under these decisions, it is submitted that for reorganization purposes, a bondholder stands in no different position from a stockholder with respect to an interest in the assets and affairs of a corporation."

Answering the argument in note 3 on page 9 of the government's brief a reading of clause (B) shows it only requires the stockholders of the old corporation to receive 80 per cent of the stock of the new one. If they get it the statute is satisfied. It does not require them to get it for their stock or their bonds.

The Application of Clauses (C) and (D) to the Case at Bar

These clauses (quoted on page 14 hereof) were thrown in by Congress as catch-all clauses.

Under (D) a change in place of organization "however effected" is a reorganization.

That happened here. The transferor corporation was organized in Nevada (R. 23). The petitioner was organized in California (R. 22).

Before petitioner was organized all the stock of the old company except Mr. Pinney's had been bought by it and Mr.

Pinney with his ten shares was its sole stockholder since September 2, 1931. (Finding and stipulation R. 24). From that date to April 1, 1932 when petitioner was organized (R. 25) the sole interest in the old corporation's property was unquestionably in its bondholders and its sole stockholder Mr. Pinney. They kept that identical interest when they merely changed the state of organization. Hence Clause (D) applies.

The Continuity of Interest Theory and Its Application Here.

The requirement of some continuity of proprietary interest in property transferred did not appear in the Statute, which was in the same form from 1924 to 1934 when it was changed as hereinafter detailed.

In its brief in the *Kitselman* case, quoted on page 20 of taxpayer's main brief, the government stated:

> "Where, as in the present case, the bondholders were the only parties in interest in the assets of an insolvent corporation, a continuity of their interest in the assets in the bonds of a new corporation is a sufficient compliance with the Statute."

The continuity of interest theory first appeared in *Cortland Specialty Co.* v. *Commissioner*, 60 F. (2d) 937 (C.C.A. 2nd) decided in 1932. Eight years had elapsed before anyone thought it a requirement of the statute. It was evolved by the court to prevent profit on a pure sale to outside interests escaping tax and has never been invoked or applied for any other purpose.*

In *Helvering* v. *Minnesota Tea Co.*, 296 U. S. 378 (decided in 1935) this court stated at p. 384 that in the *Pinellas Ice Co.* case it "approved the conclusion of the Commis-

*In Newstadt, 43 B.T.A. 848, the Board refers to "a taxable sale lurking in disguise".

sioner, Board of Tax Appeals and Court of Appeals that the transaction there involved was in reality a sale for the equivalent of money." This court at p. 385 repeated its statement in the Pinellas case that to be a reorganization "the seller must acquire an interest in the affairs of the purchasing company more definite than that incident to the ownership of its short term purchase money notes." This court then stated: "And we now add that the interest must be definite and material; it must represent a substantial part of the value of the thing transferred."

The rule of these cases has been reiterated. *Groman* v. *Commissioner*, 302 U. S. 82, 89; *Helvering* v. *Bashford*, 302 U. S. 454, 456. See Mim. 4555, C.B. 1937—1 p. 244.

In *Le Tulle* v. *Scofield*, 308 U. S. 415, the rule was stated as follows, at page 420:

> "We have said that the statute was not satisfied unless the transferor retained a substantial stake in the enterprise and such stake was thought to be retained where a large proportion of the consideration was in common stock of the transferee."

At page 421 the decision in the *Le Tulle* case was stated by this court as follows:

> "Where the consideration is wholly in the transferee's bonds or part cash and part such bonds, we think it cannot be said that the transferor retains any proprietary interest in the enterprise."

That is not the situation in the case at bar. Here unquestionably a proprietary interest was retained by the old company's sole stockholder and by its bondholders.

It was not until 1934 that Congress wrote the requirement of continuity of interest into clause A of the Statute

by requiring that the consideration for the assets be solely voting stock. (A circumstance in support of the statement quoted from the Yale Law Journal on page 9 hereof, that the test of continuity of interest only applies to the consideration received at the conclusion of the transaction.)

The Committee reports expressly stated this 1934 provision was a change in existing law. (See page 34 of our main brief for report and note reference to "these changes".)

> "It is not our function to engraft on the language of the statute additions which we think the legislature logically might or should have made" 312 U. S. at page 605.

A bare reading of the Statutory definition of reorganization discloses loss of control by the stockholders of the transferor does not prevent the transaction being a reorganization within many of its clauses and this court has so stated. *Nelson Co.* v. *Helvering*, 296 U. S. 374, 377, *Fisher* v. *Commissioner*, 108 F. (2d) 707 cer. den. 310 U. S. 627. Under the Statute, as it now reads, the owner of the corner grocery could transfer it to the Great Atlantic & Pacific Tea Co. for 300 shares of its voting stock and it would meet the statutory definition of reorganization (See sec. 112 (g) (1) (c) of the Code). This the department's regulations concede.

The cases cited on page 11 hereof, holding reorganizations existed, show some percentages of the transferee's stock which this and other courts have held satisfied the requirement of continuity of interest. Under those cases that requirement is alone met in the case at bar by the issuance of 1000 shares of common stock to the sole stockholder of the old company (See page 11 hereof) disregarding the balance issued to its bondholders.

Moreover while it has been held that the interest which should be continued must be a proprietary interest in the property transferred, no holding has gone beyond that. No case has held that there can exist no proprietary interest in property transferred prior to its transfer except a shareholder interest. Indeed, a reading of the statute quoted on below will disclose an individual could transfer property to a corporation controlled by him and be within it. In other words, if he transferred one of his individually owned plants to a corporation, in which he owned 95 per cent of the stock, in connection with a reorganization, it would take the same basis under Sec. 113 (a)-(7) as it had in his individual ownership, albeit there was no continuity of shareholder interest in such property. A continuity of proprietary interest would be enough.

Also all the cases in which this court held a reorganization did not exist were sales to outside interests. None of them were internal adjustments like the case at bar.

The Crucial Statute

The statute directly involved is Section 113 (a) (7) of the Internal Revenue Code which reads as follows:

> "113 Adjusted basis for determining gain or loss.
>
> "(a) Basis (Unadjusted) of Property. The basis of property shall be the cost of such property; except that—
>
> "(7) Transfers to corporation where control of property remains in same persons. If the property was acquired after December 31, 1917, by a corporation in connection with a reorganization, and immediately after the transfer an interest or control in such property of 50 per centum or more remained in the same persons or any of them then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of

loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. This paragraph shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer.'"*

Under its words "an interest or control of 50 per centum or more" must remain in "the same persons or any of them" • • • "immediately after the transfer".

In the first place either a 50 per cent "interest or control" in the property is enough. Both interest and control are not required.

What is meant by the word "interest"? The Bureau of Internal Revenue in G.C.M. 7472; C.B. XI-1 p. 184 at p. 191 construes it as follows:

"The term 'interest' is a very broad one, clearly much broader than the term 'ownership' and since it is used in a provision having reference only to property owned by a corporation and acquired in connection with a reorganization (commonly, if not universally, in connection with a transfer by one corporation to another) the conclusion is irresistible that the term in section 204 (a) (7) is used to designate that ultimate or beneficial species of rights, in the nature of ownership which the individual shareholder has in property the direct ownership of and the beneficial and legal title to which is in a corporation of which the individual is a shareholder. Any other construction would render the statute totally meaningless, for if the statute contemplates ownership, either legal or equitable, it is obvious that the acquiring corporation has the whole

*Sec. 113 (a) (7) of the Internal Revenue Code, as now existing, expressly eliminates the necessity of retention of a 50% interest where the transfer was made after December 31, 1935. In such case if there was a reorganization the basis is the same.

legal and equitable ownership, and accordingly no interest or control of any percentage can be said to remain in anyone 'immediately after the transfer.' "

With unanswerable logic the above ruling points out that the interest in the property to which the Statute refers is not the legal title (as the government seems to contend here) but the ultimate beneficial interest in the property. In *Consolidated Rock Products Co.* v. *Du Bois*, 312 U. S. at page 529, note 27, this court states the old stockholders "admittedly had no equity in the enterprise." Since the stockholders had no equity necessarily the bondholders had it all and they retained this interest and the Statute was complied with when they received over 50 per cent of the stock of the transferee.

The Bondholders of the Insolvent Corporation Had at Least a 50% Control Over Its Property and It Remained in Them After the Transfer.

Sec. 113 (a) (7) quoted on page 23 hereof does not require the 50 per cent interest or control to remain in the transferor corporation after the transfer. This will be conceded. (See department's ruling quoted on page 24 hereof.)

Because of the insolvency of the transferor corporation control of its property passed from its stockholders to its bondholders.

As correctly stated in the government's brief in this court in the *Kitselman* case (quoted at page 15 of taxpayer's brief in No. 328 herein), "The only reason the stockholders did not participate in the plan was that their stock represented no assets and was valueless, and therefore they were without right to speak. See *In re* 620 Church St. Corp., 299 U. S. 24, 27."

The bondholders alone controlled the property months prior to the transfer and had a right to do what they pleased with it and after the transfer the bondholders owned all the stock of the transferee except 1000 shares issued to the sole stockholder of the transferor. Hence a 50 per cent "control" in the property remained "in the same persons or any of them" after the transfer. For construction of the words "or any of them" see *Monarch Electric Wire Co.* v. *Commissioner*, 38 F. (2d) 417 (C.C.A. 7th). *Fairbanks Court Co.* v. *Commissioner*, 84 F. (2d) 17; cer. den. 299 U. S. 582.

This control passed to the bondholders contemporaneously with the insolvency of the transferor. After it has passed to them they formulated the plan of reorganization and the reorganization began. Instead of deciding to reorganize and transfer it to taxpayer they might have sold the property to a stranger for cash.

If the bondholders had a 50 per cent control of the property transferred before the transfer it need not be asked whether the bondholders had a 50 per cent interest therein. Of course, the bondholders had such a control of the property unless the court is to be completely blind to substance and reality, which it has many times declared control in tax cases.

Bondholders of a Solvent Corporation Have No Proprietary Interest in Its Property

In deciding in *Le Tulle* v. *Scofield*, 308 U. S. 415, that the bondholders of a solvent corporation have no proprietary interest in its property while it remains solvent, this court merely repeated what it had said many times and over many years.

Thus in *Hollins* v. *Brierfield Coal Co.*, 150 U. S. 371, 383:

> "Solvent it holds its property as an individual holds his, free from the touch of a creditor who has acquired no lien * * *"

Insolvency Completely Changes the Situation and Gives the Bondholders a Proprietary Interest

In the same case the court said at p. 385:

> "Becoming insolvent * * * places the property in a condition of trust first for the creditors and then for the stockholders."

In *Graham* v. *LaCross Ry. Co.*, 102 U. S. 148, 161:

> "When a corporation becomes insolvent, it is so far civilly dead that its property may be administered as a trust fund for the benefit of its stockholders and creditors. A court of equity at the instance of proper parties will then make these trust funds, which in other circumstances are as much the absolute property of the corporation as any man's property is his."

This statement is repeated in *Mellen* v. *Moline Iron Works*, 131 U. S. 352; *Blake* v. *McClung*, 172 U. S. 239, 254. In the leading case of *Northern Pacific R. Co.* v. *Boyd.*, 228 U. S. 482, at p. 504, it is said:

> "The property was a trust fund charged primarily with the payment of corporate liabilities."

In *Investment Register Ltd.* v. *Chicago M. E. Ry. Co.*, 212 Fed. 594 (C.C.A. 7th) at p. 609, where the corporation was insolvent:

> "The property virtually belongs in equity to the bondholders."

It is on the trust fund theory that transferee proceedings in tax cases are brought. *Price* v. *United States*, 269 U. S. 492, 502; *Phillips* v. *Commissioner*, 42 F. (2d) 177, 180

(C.C.A. 2nd). The Committees of Congress referred to it as "arising under the trust fund doctrine or some similar theory." (C.B. 1939-1, part 2, p. 354.) *Cf. Commissioner* v. *Keller*, 59 F. (2d) 501.

This interest of creditors as sole beneficiaries of the corporation's property comes into existence as soon as the corporation becomes insolvent and any property subsequently transferred continues to be charged with the trust for them. On the other hand, property transferred by a solvent corporation is free of trust. Creditors have no interest in it.

Finally let us put aside legal technicalities and look at the substance. Most of us who were lucky enough at some time to get more money than we needed for current bills were unlucky enough to have invested some of it in stock of a corporation that became insolvent. To say that we stockholders were the only persons who had an "interest" in the property when the corporation was insolvent and its property was being administered by the receiver for the benefit of the mortgage bondholders and under their charge is to disregard substance and reality. As was said in *Helvering* v. *Lazarus*, 308 U. S. 252, at page 255:

> "In the field of taxation, administrators of the laws and the courts are concerned with substance and realities."

A powerful statement of "practical and common sense recognition to the well defined type of business reorganization" is found in the government's brief in opposition to the petition for Writ of Certiorari, in the *Kitselman* case, which is quoted in the taxpayer's brief of *Alabama Asphaltic Limestone Company*, No. 328, herein, at page 15 thereof.

For Sixteen Years the Administrative Practice, Approved by the Courts, Uniformly Treated Bondholders' Reorganizations as Reorganizations.

In 1924 the Treasury Department ruled in I.T. 2071 published in C.B. III.-2 at page 34 that bondholders' reorganizations in which stockholders were eliminated were "the most common form of reorganization". This ruling is quoted at page 16 of taxpayer's brief in *Alabama Asphaltic Limestone Co.* case (No. 328) and your honor is requested to read it at this point. Also S. M. 2723, C.B. III—1 p. 26. Similar statements appear in court decisions. *Cortland Specialty Co.* v. *Commissioner*, 60 F. (2d) 937, 939; *Securities Co.* v. *Commissioner*, 64 F. (2d) 330, 331; *Cf. DeBlois* v. *Commissioner*, 36 F. (2d) 11, 13 (C.C.A. 1st). All textbooks likewise state it is the most common form of reorganization. Corporations 19 C.J. Sec. 1578, 1585. Fletcher (1938 edition) Vol. 15, p. 367, Sec. 7222.

In 1926 the bureau ruled the same in I.T. 2258 published in C.B. V-I p. 10.

In November, 1930 the Board of Tax Appeals ruled the same in First National Bank of Champlain, 21 B.T.A. 415.

In 1934 the Board ruled the same in Rockford Brick & Tile Co., 31 B.T.A. 537 and at page 540 cited with approval I.T. 2071 above cited.

Not until the fall of 1935 did the Board overrule these cases in *Kitselman*, 33 B.T.A. 394 and *Newberry Lumber Co.*, 33 B.T.A. 150. The overruling of the cases was based on the adoption by the Board of the continuity of interest theory now contended for by the government.

The Commissioner immediately published his non-acquiescence in these cases (as to *Kitselman* case C.B. XV-1

page 36 and as to *Newberry* case see C.B. XV-1 page 39) and appealed them to the Circuit Courts of Appeal and the bureau continued its preexisting practice.

Part of his argument in the Circuit Court of Appeals in the *Kitselman* case is quoted at pages 20 and 21 of our main brief. That court adopted his argument and reversed the Board in April, 1937, its decision being reported in 89 F. (2d) 458. Kitselman, still seeking to deduct a loss (which there was an unquestioned right to deduct if there was no reorganization) petitioned this court for certiorari. One of the grounds of petition was that the *Worcester Salt Co.* case, 75 F. (2d) 251 (the same as the *LeTulle* case) was in conflict with the *Kitselman* case. The government's brief in opposition pointed out that it was not. (For quotation from that brief see taxpayer's brief in Alabama Asphaltic Co., page 15). This court denied the writ in 302 U. S. 709. Thereupon bondholders who went through depression reorganizations and were claiming losses gave up the ghost and the Statute of Limitations barred their right to claim a loss. The government also succeeded in reversing the *Newberry Lumber Co.* case in 94 F. (2d) 447, in February, 1938.

These decisions were followed by the Board and continued to represent the Treasury attitude until sometime after *LeTulle* v. *Scofield*, 308 U. S. 415 (decided January 2, 1940) was decided.

It is submitted that in the consideration and decision of doubtful questions fundamental principles of fair play ought to play a part.

That this administrative practice under which deduction of losses was denied bondholders in depression reorganiza-

tions was known to Congress and that the reorganization provisions were retained in the law in 1934 for the purpose of preventing bondholders deducting losses in the deluge of depression reorganizations then in process clearly appears. (See report p. 36 of our main brief. Also pgs. 34, 33, 32. See statement of Acting Secretary of the Treasury in Ways & Means Sub-committee Report 73rd. Cong. 2nd. Sess. p. 9.)

Separate Tax Consequences Are Not to Be Attached to a Reorganization Sale.

A reorganization plan is treated as a unit. *Helvering* v. *Bashford*, 302 U. S. 454, 458.

The Board of Tax Appeals and every Circuit Court of Appeals has repeatedly declared separate tax consequences are not to be attached to a reorganization sale. *Howard Hotel Co.*, 39 B.T.A. at p. 1153. Cases cited in 41 B.T.A. at p. 386. More than two pages would be required to cite all the cases so holding. In the quotation from its brief at page h hereof the government states this principle is well established.

Fletcher's Cyclopedia of Corporations (Vol. 15) at Sec. 7270 states:

> "In some respects a sale followed by corporate reorganization is quite different from the ordinary foreclosure or execution sale. The former has been characterized as hardly a sale at all but a mere step in a reorganization." (Citing 20 Columbia Law Review, 733, 739; 27 idem. 132; 32 idem. 668-678.)

Again at Sec. 7281 he states:

> "However, the foreclosure sale on reorganization is more or less a formal matter, a device rather than a fact."*

In *Habirshaw Electric Cable Co.* v. *Same*, 296 Fed. 875, cer. den. 265, this Court said at page 878:

> "In the case, however, of large properties, such as those at bar, where rights and relations are very complicated, a sale disconnected with a plan of reorganization is likely to prove disastrous."

In *Louisville Tr. Co.* v. *Louisville R. Co.*, 174 U. S. 674, 682 p. 683, the Court said none but bondholders can buy where large properties are involved.

This Court has held that a transaction in form of a purchase and sale may be in effect a reorganization and is so where the purchase is without money consideration. Many states have statutes providing for such reorganization.

It must not be overlooked that prior to the "sale" in the case at bar the old corporation's sole stockholder had no equity in its assets and all the equity belonged to the bondholders. *Consolidated Rock Products Co.* v. *Du Bois*, 312 U. S. 510. However he was given an interest.

Also that the trustee for the bondholders "sold" to them. The bureau has always taken the position that a loss cannot be established by public auction where the taxpayer, through agents, is buyer and seller and that in

*The amount at which a dissenting bondholder may participate does not depend on the bid price. **First National Bank v. Florsheim**, 290 U. S. 504. **Northern Pacific Ry. Co. v. Boyd**, 228 U. S. 482, 507, 508. In Corporations, 13 American Jurisprudence, Sec. 1245, it is said: "A transaction in form a purchase and sale may be in effect a reorganization or consolidation, as, for example, when the purchase is without a money consideration and upon an exchange of stock and bonds of the new company for stock and bonds of the old."

such case no sale takes place. I.T. 1181 C.B. 1 p. 141 and Dobson, 1 B.T.A. 1082 (*Cf. Higgins* v. *Smith*, 308 U. S. 473 disregarding a sale by a taxpayer to a wholly owned corporation.)

Also the payment of a bond or note is not a sale. *Hale* v. *Helvering*, 85 F. (2d) 8. The court below said the old company got credit on a debt.

As said in *Howard Hotel Co.*, 39 B.T.A. at p. 1152, the purpose of the reorganization provisions was to maintain the *status quo* in tax matters where such "transfer is primarily a matter of form and not of substance."

In the case at bar, for months prior to the "sale" Mr. Pinney was sole stockholder of the old company and the beneficial interest in its property was in the bondholders. After the "sale" Mr. Pinney and the bondholders owned all the stock of the new transferee corporatiton. The "sale" made no change in beneficial interest.

Basis If No Reorganization

In all the cases at bar except this one the government contended below that if there was no reorganization the basis was the bid price. Here it is said the basis is the fair market value of the property at the time of the transfer. (Where this is less than the cost of the bonds and bondholders were denied losses by aforesaid rulings and court decisions at the time of the transfer an injustice will be done even if this basis is adopted.)

This shift is a wise one and dictated by more mature consideration for obviously if the bid price were decided to be conclusive all future bondholders' committees would bid the full amount of the bond issue and thus secure a basis which in many cases would exceed the depre-

ciated cost of the property to the old corporation. On the other hand, bondholders wanting to write off a partially worthless debt would bid the price suitable to accomplish what they desired to write off. Also in past reorganizations, where no money passed and the bid price was fixed at a figure to enable the commissions to pay the cost of the reorganization, a glaring injustice would result from making the bid price the basis.

The reasons why market value at the time of the transfer is the basis if there was no reorganization are fully stated in the government's brief in opposition in *West Production Co.*, No. 674 herein, and reference is made to that brief.

This Court will not overlook that if the administrative practice, continued for sixteen years, is now overturned thousands of cases will be reopened and hundreds of millions of dollars in property must be now valued at the date of the reorganization sale. When one considers the questions as it affects the railroads alone the task will be appalling. Also there will be a flood of valuation litigation and negotiations and controversy extending over years.

In 1934, in commenting upon a preliminary report of a subcommittee of the Ways & Means Committee (73rd Cong. 2nd Sess., p. 9) the Acting Secretary of the Treasury said:

> "To attempt to evaluate the property received in exchange would be an enormous administrative task * * * It will be noted that exempt exchanges are strictly limited to transactions in which it would be administratively difficult to determine any gain or loss."

Consider the facts at bar. The Hotel was completed in 1928. Its cost, with additions to August 2, 1932, was $769,384.78. The Commissioner valued it as of August 2, 1932 at $370,955.32. What is the rule for valuing property in the trough of the depression?

These considerations reinforce the argument that if any change is to be made at this late date it should be by legislation where the problem can receive the thorough consideration it deserves from the standpoint of both the taxpayer and the government.

CONCLUSION.

As we have said, if a corporation cannot be reorganized when stockholders are eliminated most depression reorganizations are outside the Revenue Act, yet the amendment to the Bankruptcy Act (quoted in note at p. 8 of government brief in No. 286, *Southwest Consolidated* case) indicates Congress understood insolvent corporations were within the reorganization sections and required to use the transferor's basis in its reference to property transferred in a bankruptcy proceeding "to any person required to use the debtor's basis" (for history of this Act see page i in appendix hereof.) (The Treasury so recognized in C.B. 1938—2 at page 499.)

On page 10 of its brief the government states:

> "The proprietary interest in the old corporation was shifted from its stockholders to its creditors. By the same token, immediately after the transfer, neither an interest nor control of the property of 50% or more was retained in the prior owners, as specifically required by Section 113 (a) (7) of the Revenue Act of 1932."

The point it overlooks is that this interest shifted months before the transfer. If it had shifted a week or a day be-

fore the transfer Sec. 113 (a) (7) would, by its plain words, be clearly applicable and was obviously intended to be. *Shipowners Tugboat Co.*, 4 B.T.A. 403.

In the article on "Classification of Foreclosure Mergers As Tax Free Reorganization Exchanges," in 51 Yale Law Journal, 128, in which the cases at bar are discussed at p. 132, it is said of the continuity of interest rule:

> "As formulated, the rule requires that the owners of the equity interest[24] in the transferor corporation retain a continuing proprietary interest in the transferee corporation after the reorganization exchange."

Note 24 states as follows:

> "The stockholders own the equity interest in a solvent corporation. It is submitted that the equity interest passes to the bondholders upon insolvency."

The note concludes at p. 137:

> "Thus it would seem that there has been a reorganization in these receivership cases both within the literal definition in Section 112 and the underlying purpose of the tax free exception since no realized gain has been shorn from the business res."

One very important point not to be overlooked is that Section 113 (a) (7) is also designed to prevent the basis being stepped up. For invested capital, upon which war excess profits taxes are based, this is vital. Invested capital is defined as what is invested in the business or the value of property paid in for stock at the time paid in. War plants, oil companies and companies such as LaBelle Iron Works, 256 U. S. 377, which have greatly appreciated in value will be paid into new corporations to get this increased value as an invested capital basis if the meaning of "reorganization" in Section 113 (a) (7) is so restricted as to make it easy to avoid this section. It cuts both ways.

For example, if 50 per cent of the stock in the new corporation must be issued for stock in the transferor (as the government here claims) before Section 113 (a), (7) is applicable it will be an easy matter to avoid it and as a result step up the basis of property by merely causing 51 per cent of the stock of the transferee to be issued to the same people who own the transferor, for new money or other considerations.

As to the quotation from the Committee report on pages 29 and 30 of government brief in No. 286 herein, it is important to note transfers of bonds in reorganizations were exempted from the stamp tax for the reason that the changes were purely formal. Section 724 of the 1932 Act read in part: "Provided further, that the tax shall not be imposed on deliveries or transfers of bonds in connection with a reorganization." Thus indicating Congress understood such a thing did not affect the reorganization. It knew most bonds were being then changed into stock. The Committee in its report on the 1932 law said: "Transfers of bonds in connection with tax free corporate reorganizations are exempted." (C.B. 1939—1, Part II, p. 531.)

The continuity of interest theory should not be read into the statute beyond its present borders. Since 1934 it has provided a "statutory merger" is a reorganization. In many states a statutory merger may be made if the stockholders of one of the merging companies take only bonds. Yet, as to them, the statute does not mean what it plainly and unambiguously says.

We believe the Board was correct in its decision that the acquisition of the furniture and fixtures was not in a reorganization for the reasons stated by the Board and on page 10 of the government's brief herein and accept that part of the decision.

We ask that the decision of the Board of Tax Appeals be affirmed and that of the Circuit Court of Appeals reversed.

All of which is respectfully submitted.

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APPENDIX A.

Remarks of Hon. George A. Paddock of Illinois in the House of Representatives Monday, Aug. 25, 1941.

Mr. Paddock: Mr. Speaker, the Government of the United States, with its almost complete control over the property of its citizens, owes them a high degree of fairness and honesty in exercising these great powers. In recent cases now before the courts our Treasury Department has attempted to tax as "profitable" transactions where actual losses were plainly evident, and conceded by the Department. Because of these attempts to collect taxes without any justification except a technical and arbitrary interpretation of the law, I have introduced H. R. 5617.

In brief, my bill prevents the attempt to collect profits taxes on transactions involving actual losses, following reorganizations by bondholders. It directly protects hundreds of thousands of individuals and corporations, former purchasers of bonds, who took over in reorganization the property their securities covered. It clarifies the present law which our Treasury Department interprets to authorize profit taxes on differences between reorganization values and later resales, even though this resale value was actually less than the original cost to the taxpayers.

For a concrete case illustrating the injustice which H. R. 5617 will correct, I cite the Federal Land Bank of Milwaukee, which issued bonds for which it secured about $15,000,000, mostly from small investors. It loaned this money on farm mortgages. In 1926 it was declared in-

solvent, and in 1932 the Farm Loan Board approved the transfer of its assets to a new corporation organized by the bondholders. This transfer was by means of a public sale at which the bondholders were the only bidders, and the nominal upset bid price was $2,351,000. No money passed. The bondholders might just as well have bid $15,000,000. It would have cost them no more, and would have eliminated the controversy.

Eventually the reorganized company liquidated the mortgages for about $10,000,000, so there was an actual loss of over $4,000,000. If the transfer of the assets of the land bank to the new company be treated as a reorganization, this loss will be given effect. Otherwise, a tax will be due on an alleged profit of $7,649,000. The bondholders were in control before and after the transfer.

In 1932 the Treasury ruled that there was a "reorganization," and the bondholder could deduct no loss. Now that the statute of limitations has run against the bondholders, the Treasury has reversed its position, and claims its former ruling was wrong, that a deductible loss was realized in 1932, and a new base for the computation of profit and loss and the calculation of depreciation was then established.

The decision depends on the definition of reorganization. If there is a reorganization, the new company assumes the old company's base, and the transaction is not considered completed as to bondholders and stockholders. They retain the original cost as a basis of computing profit or loss when they dispose of the substituted securities they receive in the reorganization.

The Board of Tax Appeals has denied the Treasury's present contention. So have the Circuit Court of Appeals for the Second, Fifth, and Tenth Circuits. However, it has been sustained by the Circuit Court of Appeals for the Ninth and Eighth Circuits, and the decision of the Ninth Circuit in the case of Marlborough House is now pending in the Supreme Court.

I submit, Mr. Speaker, that we ought not to subject taxpayers to the hazard of what the Supreme Court may decide, but should put the question at rest now by adopting this amendment to settle the matter beyond doubt.

I do not know how many people, poor and rich, will be protected against unjust taxation by this bill. To calculate the number would involve a tabulation of the countless reorganizations which followed the crash of 1929. If we include the policyholders of the insurance companies, which invested many millions in these bonds, almost every American family will benefit somewhat by its provision.

Best of all, by enacting this bill, we will prevent the force of our Government from being used, under color of law, to attempt unjust transactions at the expense of its own citizens.

APPENDIX B.

Analysis of Decision Below

The court below in its opinion states:

> "Neither the Hotel Company nor the Operating Company got anything for its property except the satisfaction or partial satisfaction of certain indebtedness. Neither received any stock or bonds of the taxpayer. Neither retained any stake or proprietary interest in the corporate enterprise in which theretofore it had engaged. Hence, the transactions whereby the taxpayer acquired the property were mere sales or exchanges."

It does not follow that no reorganization took place because the transferor corporation did not get anything for its property. As Judge Learned Hand, with this opinion before him, pointed out in *Helvering* v. *New Haven & Shore Line Ry. Co.*, 121 F. (2d) 985, page 987:

> "It is true that the Taxpayer did not deliver its shares to the predecessor, but to the predecessor's bondholders; but the section does not declare that the buyer must deliver to the seller; only that the buyer shall acquire the properties from the seller in exchange for the buyer's shares. It would be a peculiarly fatuous formality to require the shares to pass through the seller to its shareholders; and the Commissioner does not so assert."

Because of the mistake pointed out by Judge Hand the court below reaches the conclusion, "hence the transactions" whereby the taxpayer acquired the property "were mere sales or exchanges."

As to the attempt to isolate the trustee's sale see page 31 hereof. Also the extinguishment of the bonds was neither a sale nor an exchange. *Fairbanks* v. *United States*, 306 U. S. 426; *Hale* v. *Helvering*, 85 F. (2d) 8.

The court below then states the *Kitselman* and *Newberry Lumber* cases were "in effect overruled by *Le Tulle* v. *Scofield*." This is a mere fiat wholly devoid of a single line of reasoning.

The court below also states:

> "In the case at bar, the transferor's stockholders get nothing."

How erroneous this is appears at pages 10 and 11 of this brief.

The court below also states an interest of 50 per cent or more did not remain in any of the same persons as before. "For prior to the transfers the taxpayer had no interest or control in any of the property, but was merely a creditor of the owners."

This statement is also incorrect for, because the old corporations were insolvent, taxpayer had a 95 per cent beneficial interest in its property prior to the transfer, as fully pointed out in the foregoing brief and also control over it.

The above is the reason that the second and tenth Circuits refused to follow this opinion.

APPENDIX C.

Page to Page Answer to Government Brief in No. 286 Therein (Southwest Consolidated Case)

Since the government makes the above its main brief the following analysis of it is submitted:

On page 6 the government says its position: "at the same time is fair to creditors since depreciation in the value of their individual investments would be reflected in a capital loss on exchange of their claim for stock". The government procured judicial decisions denying them this loss and, after the Statute of Limitations has barred their right to claim it, now asks the court to give it a tax windfall and tax as income any part of this loss a creditor chances to recover.

As to the bottom of page 6 and top of page 7, the only question is whether the creditors had either a 50 per cent interest or control in the property prior to the transfer—not whether they were "equivalent of the corporation or its stockholders before the foreclosure sale."

At the bottom of page 8 it cites the recent G.C.M. 22528, which holds that if a bond is exchanged for stock the debt is "cancelled." This must be decided by the courts in cases in which it arises. It should not be decided without mature consideration and the benefit of the expert view of the Board of Tax Appeals.

Answering the statement on page 11, it is obvious that *LeTulle* v. *Scofield* did not establish the principle that a

creditor interest in an insolvent corporation was not a proprietary interest because the corporation in that case was not insolvent. If it had established such principle the Board would not have decided as it did in the cases now at bar.

On page 12 it is stated where an existing investment is continued in a different form "it is understandable that the owners of that investment should be permitted to retain the same basis for tax purposes."

If this statement is carried to its logical conclusion, the taxpayer here should prevail for the bondholders and the sole stockholder were the only persons interested both before and after the transfer.

As an argument for fairness, page 14 is inapplicable since no loss was allowed and the Statute of Limitations now bars the right to claim one.

The rule stated on page 15 to be established by *LeTulle* v. *Scofield* is correct but that is not the situation in the cases at bar. With reference to the last paragraph on page 15 it was not the transfer but the insolvency of the old company that shifted the interest and also the control. (See page 27 hereof). As to page 17, the creditors acquired the equity interest before they surrendered their claims. Also the bondholders became equitable owners of the old company's assets on its insolvency and retained such interest after the transfer.

As to the claim on page 19 that the transaction may be treated as involving two separate steps (1) the sale and (2) the transfer to the new company, the cases hold the con-

trary. As stated in the government brief in the *Kitselman* case. (quoted page 15 taxpayer's brief in No. 328):

> "It has long been established, in the application of the pertinent reorganization provisions, that the component steps of what may be regarded as a single general plan looking to the reorganization of a corporation will not be treated separately".

In *Commissioner* v. *Kolb*, 100 F. (2d) 920, 925:

> "The Commissioner's brief properly contends that all the component steps of the plan should be regarded as a single transaction."

Page 20 treats the Committee as a separate purchaser whereas it was a trustee for the new company. That the purchasing committee buys and holds the property in trust for and must convey it to the new corporation see Fletcher, Vol. 15, Sec. 7280. (1938 edition.)

The position taken in note 13 on page 23 is untenable for the reasons stated on page 11 hereof.

On page 26 it is suggested that if the assets before the sale rise in value to exceed the debts the stockholders are entitled to the excess. Who knows such a case? Certainly the case at bar was not such. "Taxation," as this court has said, "is eminently practical."

With reference to the last paragraph on page 26 a default had taken place here and upon that event equity transferred the equitable title to the property to the bondholders and also the control of the property to the bondholders.

At the bottom of page 27 and top of page 28 an attempt is made to get around this by saying a taxable shift took place. The government in the *Kitselman* case established

the contrary. Also bonds are debts and they are not deductible as worthless debts where they are exchanged for valuable stock. The case of *Helvering* v. *Midland Ins. Co.*, 300 U. S. 215 is analyzed in the government's opposition to taxpayer's petition No. 674 herein (West Production Co.) and this analysis shows it inapplicable here. Also it does not deal with a reorganization.

As to pages 28 to 31 a sufficient answer is that the Committee Reports expressly state the transition from bondholder to stockholder might be made and a reorganization exist.

If as sale, which takes place in nine out of ten reorganizations, is held to take the case out of the reorganization provisions they will be largely nullified.

The legislative history of the section of the Bankruptcy Act quoted in note on p. 8 of government brief in No. 286 herein (Southwest Consolidated Co.) is that the decision in *United States* v. *Kirby Lumber Co.*, 284 U. S. 1, was construed to mean if debt was cancelled or reduced and thereby the debtor was rendered solvent the debt cancelled was taxable income. Tax on such "income" being more than they could pay, bankrupts applied to Congress for relief and U.S.C. Title 11, Sec. 795 was enacted declaring no taxable income was realized from such cancellation. The treasury demanded the basis be reduced by the amount of debt cancelled but Congress in the Statute quoted on p. 8 of the government's brief in N.o 286 herein provided this reduction should not go below the value of the property. (For Committee Report see C.B. 1940—2 p. 598, 599, 600.)